Vol. 20, No. 7 **www.innobriefs.com**

Innovation News Briefs

May 20, 2009

Some Further Reflections on the Future of PPPs

Andrew Bary's piece "The Long and Binding Road," in last week's Barron's has been widely noticed, especially after it was picked up by the Wall Street Journal's online edition. "The credit market collapse and political opposition have all but killed the U.S. highway privatization trend," the respected commentator opined in his article. What is more, Bary wrote, the Indiana Toll Road deal "was one of the most illogical prices paid for any major piece of transportation infrastructure during the bubble period of 2005 to 2007," suggesting that Macquarie made a huge miscalculation. Gov. Mitch Daniel's comment ("It was the best deal since Manhattan was sold for beads...") did not help, implying that the State got the better of the naive Macquarie. The article concluded, "for toll road investors, what had promised to be a pleasant ride has turned into a painful trip," citing Macquarie's shares tumbling 50% in the past year. The negative news did not stop there. There was the "No Bids for Florida's Alligator Alley" announcement by Florida DOT (partially offset by the recently negotiated Florida I-595 HOT lane concession and the prospective resuscitation of the Port of Miami concession project); the withdrawal of one of the two remaining bidders, Global Infrastructure Partners, for U.K.'s Gatwick Airport in the wake of the collapse of the Midway Airport deal ("It's no longer a uniquely U.S. problem" one of our readers commented) ; and the news that the Jackson Airport Parkway toll concession is being delayed by the credit crunch. On Capitol Hill, Senators Bingaman and Grassley made news and raised concern with their proposals to change the tax treatment of brownfield P3 concessions and create other disincentives for private infrastructure investment. All in all, it's been a sobering month for PPP advocates.

The good news in your editor's judgment is that, despite these recent reversals, the longer-term prospects for PPPs and private investment in infrastructure appear surprisingly good. A favorable policy climate at both the state and federal level is one contributing factor. The Mississippi, North Carolina and California legislatures have passed PPP-enabling legislation, suggesting that the sentiments among state legislators are running in favor of private investment in roads and other infrastructure. On Capitol Hill, the earlier signs of suspicion toward PPPs by certain influential legislators have been replaced by modulated expressions of support. This suggests that PPPs, the Infrastructure Bank, TIFIA, Private Activity Bonds and other supportive private financing measures will receive favorable treatment in the upcoming surface transportation legislation, the Bingaman-Grassley initiative to the contrary notwithstanding.

Signals from the Administration are equally encouraging. U.S. DOT guidance on the discretionary $1.5 billion grant program included in the Recovery Act for projects of national/regional significance includes positive references to the role of private participation. Transportation Secretary LaHood, our sources tell us, has made it clear to recent visitors that PPP will have to be part of the mix in new transportation funding.

Of course, from the private sector point of view, there never was any doubt about the appeal of investing in private infrastructure because highways, bridges, ports and even parking garages are long-lived assets that bring a steady and predictable stream of income. There are signs that, despite the recent financial upheaval, institutional investors such as pension funds remain interested in infrastructure as an investment asset class. And they find willing partners in the cash-strapped state and local jurisdictions which have few other options to private capital to supplement their inadequate public resources when new infrastructure is concerned.

However, as the weight of opinion on last week's National Journal Transportation Blog suggests, the nature and structure of PPP transactions will undergo a significant if not radical modification. Highly leveraged deals, inflated valuations based on overly optimistic expectations of future operating income (i.e. earnings after interest, taxes, amortization and, importantly, capital expenditures beyond routine maintenance), and dramatic upfront payments are a thing of the past. Borrowing costs will rise as the capital markets take a more conservative approach to risk assessment. Greater attention will be paid to economic uncertainties as they affect toll receipts and to the need for capital improvements over the entire life of the concession. As one blogger, former Deputy DOT Secretary Michael P. Jackson remarked, "smart investors, and especially pension funds and other investors seeking greater stability, will *not* try to match double-digit gains of successful venture capital investors." They will have to be satisfied with more conservative returns.

In short, the financial crisis will cause investors to scale back expectations and experiment with financial innovation. The rising popularity of "availability payments" ---which one of our readers characterized as "simply a long-term loan couched in fancy new terminology"--- is one example how the financial services industry is responding with creative new approaches to the changing conditions of credit availability.

Lurking in the background as another blogger noted, is the fact that Wall Street and financial entities are mistrusted by a large fraction of the population and the political leaders. The recent financial crisis has magnified this anti-business feeling and may affect attitudes toward PPPs. However, the need for investment capital will presumably overcome the public uneasiness about letting private capital play a role, if adequate safeguards "to protect the public interest" are provided.

So my reaction to my colleague Andrew Bary is is to paraphrase Mark Twain: his report of the PPPs' demise is greatly exaggerated.